SB 401

CONNECTICUT VOICES FOR CHILDREN

33 Whitney Aver
New Haven, CT 065
Voice: 203-498-42
Fax: 203-498-42
www.ctkidslink.c

Testimony Concerning
Raised Bill 401, An Act Concerning a Study of a Next Generations Industries Tax Credit Program

Shelley Geballe, JD, MPH
Commerce Committee
March 4, 2008

Dear Senator LeBeau, Representative Berger, and distinguished Members of the Commerce Committee:

I am President and co-founder of Connecticut Voices for Children, a research-based public education and advocacy organization that works statewide to promote the well-being of Connecticut's children, youth, and families. Since 1997, CT Voices' work has included a focus on the state budget, looking not only at expenditures for the benefit of children and families, but also at how state revenues are collected, and what revenues the state decides not to collect through various tax expenditures including tax credits.

We testify today to support the process proposed in Raised Bill 401, An Act Concerning a Study of a Next Generations Industries Tax Credit Program. The bill would enable a more deliberate assessment by the Commissioner of the Department of Economic and Community Development (DECD) both of what emerging industries might benefit from a tax credit, and how a tax credit might best be designed. We would respectfully suggest, however, the following amendments to this study bill:

- **That the DECD Commissioner's study be closely tied to DECD's new Economic Strategic Plan, such that any incentives proposed in the study be consistent with the Plan.** CT Voices has supported DECD's development of an Economic Strategic Plan as a tool to guide the state's economic development investments so they are most strategically, and effectively, made. This study, and any other decisions the General Assembly makes about tax credits or tax expenditures, should be guided by this Plan, or the time taken to create the Plan will have been wasted.

- **That the DECD Commissioner's study be expanded in its scope to look at *all* tax credits currently being awarded in the state to assess if they are consistent with the goals of its Economic Strategic Plan, if they are providing adequate return on the state's investment and, even if they are "paying for themselves," whether the resources could be deployed in other ways that would promote even more effectively the state's economic development.** Last month, CT Voices released an Issue Brief on Connecticut's business tax credits (attached). It examined the many business tax credits, describing the various design features (for what activities credits were awarded, how the credit amount was calculated, for how long credits could be carried-forward, if credits were capped by taxpayer, or in total, etc.).

  The report documented the substantial projected revenue loss from all business tax credits ($338.3 million in FY 09 according to the Office of Fiscal Analysis), the wide variation in the credits' design features, and the vast differences in projected FY 09 revenue loss from the different credits (more than 1/3 of total projected FY 09 revenue loss is attributed to the three "film" tax credits -- more than *five times* Connecticut's investment through tax credits in research and development and research and experimentation). This suggested to us that the economic development being

promoted through the state's tax code was not being monitored nearly as closely DECD monitors its economic development through grants and loans. In fact, the fact that so many of the tax credits are uncapped means that DECD actually has very little control over the state's whole economic development "portfolio" and how it is balanced across industries and companies. The ultimate size of the state's investment in any business or industry that qualifies for "uncapped" tax credits is outside DECD's control.

Ideally, DECD should produce an *Integrated Economic Development Budget* that reports on *all* public investment in economic development regardless of form (e.g., through grants, loans, tax expenditures, and major tax code changes) by all public agencies and quasi-public agencies. In this way, at least *one* state agency has a hold on how Connecticut's economic development resources are being deployed across business, industries, programs, and services.

- **That the DECD Commissioner's study of "next generation industries" tax credits, be expanded to include a study of *all* tax credits, include a set of objectives and standards by which the success of all the state's tax credits can be measured.** Seven years ago, the CT Auditors of Public Accounts' *Performance Audit* of DECD's State Financial Assistance Monitoring concluded:

There should be objectives and standards or criteria relating to improving the State's economy, as well as a method of measuring achievement of these objectives, for all State funding that has been set aside to improve the economic climate in the State....Criteria, objectives, goals and procedures need to be established and available; the success or failure of each financial assistance project should be measured, as well as the total success or failure of the program, in compliance with Connecticut General Statutes, Section 32-1i.

CT Auditors of Public Accounts, *Performance Audit, State Financial Assistance Monitoring, Department of Economic and Community Development* (July 3, 2001), p. 25.

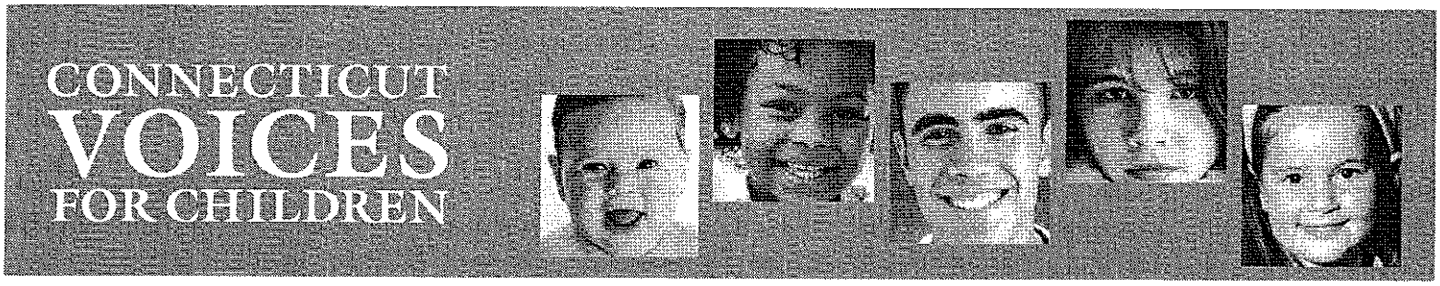
This same rigor should be applied to economic development encouraged through tax credits. In defining a set of objectives and standards, the Commissioner could be guided by a set of goals set by CBIA for keeping Connecticut's economy competitive, as follows:

If Connecticut's economy is to remain competitive or expand, its economic development activities must:

1. *Increase the overall productivity and incomes of its workers and residents.*
2. *Maintain a high level of employment and job quality for all citizens.*
3. *Create middle-class job opportunities for the jobless and the working poor.*
4. *Generate revenues needed to make further investments in education, government, services, amenities, infrastructure and an enhanced quality of life.*

CBIA, *Connecticut's Economic Development Incentives: Separating Fact and Fiction* (April 2001), p. 12.

Thank you for considering this testimony.



Business Tax Credits:
The Blank Check in Connecticut's Economic Development Portfolio?

Shelley Geballe, JD, MPH

February 10, 2008 (revised)

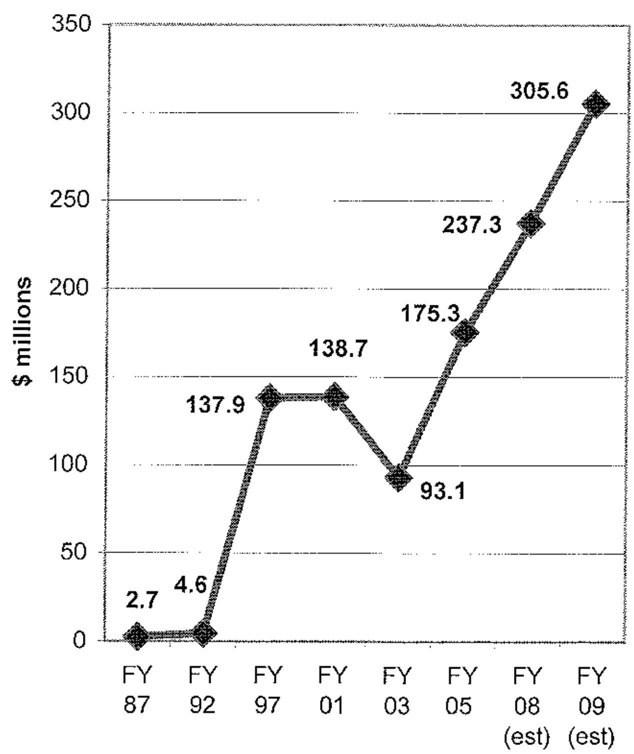
Connecticut increasingly relies on tax credits to promote its economic development. Economic development is encouraged not only through appropriated funds (grants, loans, bond funds) but also through our tax code. Financial benefit is provided – as a matter of right to those who meet the statutory criteria -- through various "tax expenditures." "Tax expenditures" are tax credits, exemptions, exclusions, deductions, and rate reductions that preferentially benefit a subset of taxpayers, reducing their tax liability below what they otherwise would be required to pay or, in some circumstances, providing a cash payment to a taxpayer with *no* business tax liability at all.

Using tax credits to promote economic development avoids the constraints of the state spending cap. Unlike grants from the Department of Economic and Community Development (DECD), for example, tax credits are not "appropriated" spending, so are not subject to the spending cap. As the graph to the right illustrates, rapid growth in tax credits followed passage of the state spending cap in the early 1990s.

Connecticut's revenue loss from corporation business tax credits has increased *113-fold* since 1987. In 1987, Connecticut had a total of nine credits against the corporation business tax. In that year, 289 corporate tax returns claimed a total of $2.7 million in tax credits. By 2003, the number of credits had increased to twenty-three, and 7,266 returns claimed a total of $93.1 million.[1] OFA now projects a $305.6 million revenue loss in FY 09 from corporate business tax credits.[2] This is 113 times greater than the revenue loss from corporate business tax credits 20 years ago and nearly 6 times greater than the total FY 08 budget of Connecticut's Department of Economic and Community Development (including its bond and carry-forward funds).

The projected $305.6 million revenue loss in FY 09 from corporate business tax credits also equals 63% of total corporation business tax revenues projected for FY 09 (net of credits). That is, for every hundred dollars in FY 09 corporation business taxes that are projected by OFA, there will be 63 dollars that are *not* collected because of tax credits. This ratio exceeds the 2005 ratio, when corporate tax credits were equal to 46% of corporate business tax paid (a ratio that far exceeded comparable ratios in Massachusetts - at 12%, and New York - at 18%).[3]

REVENUES LOST THROUGH CORPORATE TAX CREDITS, FY 87-FY 09 (est.)



New Haven Office: 33 Whitney Ave. • New Haven CT 06510 • Phone: 203.498.4240 • Fax: 203.498.4242 | Web Site: www.ctkidslink.org
Hartford Office: 53 Oak St. Suite 15 • Hartford CT 06106 • Phone: 860.548.1661 • Fax: 860.548.1783 | E-mail: voices@ctkidslink.org

Credits against other business taxes also have increased. In FY 95, there were two tax credits against the public service companies tax, with an estimated revenue loss of less than $0.2 million and one tax credit against the insurance premiums tax with an estimated revenue loss of $0.2 million.[4] OFA now projects a $5.5 million revenue loss in FY 09 from the six credits against the public service companies tax, and an additional $27.2 million revenue loss in FY 09 from the thirteen credits against the insurance premiums tax.[5]

No comprehensive economic development plan seems to guide the adoption of new tax credits. OFA estimates a $338.3 million revenue loss in FY 09 on account of 37 different credits against the corporate business, public service company and insurance premiums taxes. As the following table suggests, no comprehensive economic development plan seems to have guided the choice of activities that these tax credits seek to encourage.

Tax Credits To Be Claimed In FY 09	Projected FY 09 Revenue Loss (in millions)	% of total value of projected FY 09 tax credits
Film (Industry, Infrastructure, Digital Animation)	$116.0	34.4%
Fixed capital	$60.0	17.7%
Historic rehabilitation (homes, mixed use)	$51.2	15.2%
Electronic data processing	$40.0	11.8%
Job creation	$12.0	3.5%
Research and experimentation	$10.0	3.0%
Sale of tax credits	$7.5	2.2%
Housing program contribution	$6.5	1.9%
Displaced worker	$6.0	1.8%
Insurance reinvestment	$5.5	1.6%
Research and development	$5.0	1.5%
Machinery and equipment	$2.5	0.7%
Human capital	$2.5	0.7%
Neighborhood assistance	$2.5	0.7%
Remaining 20 credits (total)	$11.1	3.3%
TOTAL	$338.3	100.0%

Source: Office of Fiscal Analysis, *FY 08-FY 12 General Fund and Transportation Fund Budget Projections and Fiscal Information* (November 15, 2007), pp. 27-29.

Indeed, *more than one-third* of the projected FY 09 revenue loss ($116 million, or 34.4% of the total) is attributed to the three very new film industry credits: the "film" credit ($90.5 million), the "film industry infrastructure" credit ($10 million) and the "film industry digital animation" credit ($15.5 million). The "film" tax credit subsidizes not only Hollywood-type movie productions, but also the production of commercials, videogames, sound recordings, music videos, and a wide range of other activities that fall within the credit's very broad definition of an allowable production expense.

Tax credits favor certain industries and companies over others, violating a core principle of a high quality revenue system – neutrality.[6] The Legislative Program Review and Investigation Committee's 2006 study of Connecticut's tax system reported that a "very small number of filers claim the overwhelming majority of credits" against the corporation business tax. Specifically, in 2001, 13% of all companies filing a corporate income tax return (i.e., those corporations filing a combined return) received 77% of the total value of all credits claimed.[7] Further, only thirteen corporations claimed five or more credits and the total value of the credits they claimed was about one-quarter the total corporate tax revenue lost through tax credits.[8] In fact, in 2003 *only one* of Connecticut's largest 100 companies paid more than $1 million in corporation business tax, after tax credits.[9]

The study also found that tax credit use was concentrated in certain types of industries. For example, at the time of its study, the "manufacturing" industry accounted for about 10% of all corporate tax filers but for more than 30% of the total value of corporate tax credits claimed. "Utilities" accounted for 0.3% of all corporate tax filers but claimed 15.4% of total tax credit value, while "management of companies and enterprises" were 1.9% of all filers but 12.8% of the total tax credit value.[10] That is, these three industries, together, represented just over 12% of all corporate filers, but benefited from close to 60% of the total value of tax credits claimed.[11]

Connecticut's tax credits differ in their features. Although all of Connecticut's business tax credits can be taken against the corporation business tax, about one-third also can be taken against other business taxes (e.g., the insurance premiums tax, public service corporation tax).

Most credits are calculated as a percentage of the taxpayer's tax liability or a percentage of some specified types of expenditures, while five of the credits are set at fixed amounts. For example, the enterprise zone credit equals 100% of corporate income tax liability in years 1-3 and 50% in years 4-10 for certain companies qualified by DECD as eligible for the credit. By comparison, the credit against the corporate business tax for personal property tax paid on electronic data processing equipment equals 100% of the property tax paid, while the displaced worker credit[12] equals $1,500 for each displaced worker hired.

Relatively few of Connecticut's business tax credits put a ceiling on the total amount of credits that can be claimed in a given year. As a result, the state's total revenue loss through tax credits is open-ended. About one-third of Connecticut's business tax credits are capped. That is, the amount of credits granted cannot exceed a specified amount each year (e.g., no more than $15 million in historic structures tax credits can be granted each year).

The "film" tax credit as a blank check. When PA 06-186 created the "film industry" tax credit, OFA projected a $20 million FY 09 revenue loss. When PA 07-236 and PA 07-4 modified the credit to include videos, sound recordings, and certain interactive websites and allowed the credit to be claimed against the insurance premiums tax, OFA projected an additional $8.5 million FY 09 revenue loss – for a total of $28.5 million in lost revenues in FY 09. Yet, by November 2007, OFA projected a *$90.5 million* FY 09 revenue loss from this single "film" credit, more than three times OFA's original projections. *Nothing* prevents the revenue loss from this credit from climbing further even though a 2006 report by the Federal Reserve Bank of Boston's New England Policy Center concluded that while the film credits may well generate business activity, the "film tax credits do not 'pay for themselves' by indirectly generating additional income, sales and property tax revenues."[13]

Two-thirds of Connecticut's business tax credits are *uncapped.* All firms entitled to the credit can claim it, regardless of the cumulative fiscal impact on the state. This means that nothing prevents the state's revenue loss from growing far beyond what first had been projected. These credits become, in essence, a *blank check* that steadily reduces state revenues. By comparison, economic development grants are limited to funds appropriated each year.

Uncapped credits also can cause the state's economic development portfolio to become unbalanced inadvertently. When it adopts an uncapped tax credit, the General Assembly cedes control over the ultimate size of the economic development investment encouraged by that tax credit. It no longer determines annually the very best allocation of our scarce state economic development investment resources.

Only recently did Connecticut prohibit companies from using tax credits to extinguish *all* of their business tax liability. In 2002, when the state last faced a significant budget deficit, the General Assembly limited the total value of tax credits that would be allowed against the corporation business tax and the insurance premiums tax to 70% of a company's pre-tax liability in any income year.[14]

Six tax credits are available to corporations even if they have *no* Connecticut business tax liability to offset, in that they are transferable to others with tax liability or can be sold back to the state. Three of these six transferable credits are the newly-enacted film industry, film infrastructure, and digital animation credits. For example, the new "film industry" tax credit – an uncapped credit equal to a full *30%* of Connecticut pre-production, production, and post production expenses for the wide range of productions covered by this credit (e.g., films, commercials, videogames, music videos, digital and other productions) – is transferable. That is, a company eligible for the credit because it has qualified production expenses, but has *no* Connecticut corporate tax liability, can *sell* the credit to a Connecticut corporation or insurance company that *has* tax liability to offset. Indeed, these credits are available to partnerships and limited liability companies that are *not* subject to the corporation business tax (only a $250/year business entity tax); they can *sell* the credits to companies that have tax liability to offset. There need be *no* economic relationship between the business taxpayer that eventually uses the credit and the economic activity that purportedly is being encouraged by the tax credit. OPM Secretary Robert Genuario expressed grave concerns about the proposal to create such a credit:

One reason the proposal is so costly is that the bill appears to extend corporate tax credits to non-corporate entities. This would be a major change in tax policy and would set the precedent to open up all our corporation credits to any business *or individual. We must not forget that in 1993 Connecticut passed the Limited Liability Company law permitting the formation of such entities. One of the primary benefits of such an entity is its ability to pass through income to the partner's individual tax return which is taxed at a lower rate. These lower taxed firms would now generate a corporation tax credit which they could sell to other parties. As this proposal does not have any caps on the maximum amount a firm can avail itself of, the state could be in the position of just a handful of companies benefiting handsomely, instead of using our limited resources to nurture a numerous number of entities to build a self-sustaining cluster of regional expertise and capabilities.*[15]

Similarly, qualified small businesses (i.e., with gross sales less than $70 million/year) with insufficient corporate tax liability to use their full research and development tax credits can "sell" the credits back to the state for 65% of their value. That is, although they have no corporate tax liability, they can receive a cash refund of up to $1.5 million/year to offset some of their research and development expenses.[16] A 2005 OFA analysis of the tax liabilities of Connecticut's "fastest growing" companies reported that the corporate tax paid (after credits) by the seven companies studied totaled $78,601, and the seven collectively had sought $886,044 in "buy-back" refunds for their research and development costs.[17]

The majority of tax credits can be carried-forward to offset tax liability in future years. All but thirteen of Connecticut's current business tax credits can be carried forward to offset *future* tax liability. – Credits can be carried-forward for between two and fifteen years (depending on the credit). That is, credits "earned" through certain business activity in one year can reduce state revenues for up to fifteen years later. This means that as the number of credits grows (and, in particular, the number of uncapped credits grows), the stability and predictability of state revenues also will erode.

Currently, there is no on-going process for the review of existing current tax credits and repeal of those with inadequate economic return. Only one business tax credit contains a sunset provision, assuring its review after some specified period of time.[18] Also, relatively few tax credits have been repealed.[19] Yet, the merit of each tax credit *should* be re-assessed periodically.

The Program Review and Investigation Committee's study of *Connecticut's Tax System* concluded that, "[b]ased on usage alone (not considering other measure of effectiveness)" sixteen of the twenty-six business tax credits that then existed "appear of little benefit to the state's economy, and should be eliminated."[20] The Committee also cited a study by the University of Connecticut's Center of Economic Analysis (CCEA) for the General Assembly's Finance, Revenue and Bonding Committee that concluded that the corporate rate reductions and tax credit and exemption programs enacted in the 1990s were a "mixed and small success for the Connecticut economy" and that the rate reductions had had a greater positive impact than the new tax credits and exemptions.[21] A common concern about tax credits is that they "subsidize activity not originally targeted and…provide more incentive than needed to induce the desired response."[22]

Tax credits reduce the transparency and accountability of the state's economic development efforts. Unlike economic development assistance awarded through DECD, which creates a paper trail regarding the economic benefits awarded to a corporation, the corporation benefiting, the expected benefits to the state from the award and the like, there is no comparable oversight for tax credits. Neither are the investments made through tax credits necessarily integrated into the state's overall economic development strategy, as through a "unified development budget" that reports in one place all economic development assistance, no matter what the form. As DECD creates its new economic development plan, its oversight of investments made through tax credits should be an integral component of plan implementation.

Neither are there periodic and independent economic assessments of the economic return the state is receiving from its preferential tax breaks. Indeed, the fact that some credits are transferable means there need be *no* nexus between the economic benefit conferred on the business claiming the credit and that business' economic benefit to the state.

There also is no inquiry into the opportunity cost of our current credits. If $338.3 million in tax credits were invested into *different* industries or projects, could Connecticut get even greater economic return? If the credits were repealed and the revenues now collected invested in other forms of economic development, might there be greater return on our investment?

Finally, tax credits are not subject to the same standards of transparency and accountability as direct economic aid. Unlike appropriated spending that is reviewed and reauthorized *each year* and – increasingly – is subject to a Results-Based Accountability (RBA) process, tax expenditures are *not* reviewed annually. Once enacted into law, tax credits become, and remain, "entitlements." There is no further regular inquiry by the General Assembly as to whether they are continuing to fill an important public purpose (e.g. creating new jobs). Notably, even the Corporation Business Tax Credit Review Committee – established to help provide oversight -- has failed to meet regularly, study the existing credits, and submit its recommendations, as is now required by state law.[23]

As the state economy slows, and business tax credits quietly but increasingly erode state revenues, the need to assure greater accountability for the economic return of these investments becomes ever more essential.

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[1] OFA, *Connecticut Revenue and Budget Data* (February 27, 2006). Note: the plateau in the growth of credits claimed around FY 01 resulted in part from the fact that S corporations no longer were subject to the corporation business tax, so could not claim tax credits against it. The decline in the economy, coupled with a change in the law preventing tax credits from extinguishing a company's tax liability (see note 14 below) contributed to the dip in credits claimed around FY 03.

[2] OFA, *FY 08-FY 12 General Fund and Transportation Fund Budget Projections and Fiscal Information* (November 15, 2007), p. 27.

[3] Legislative Program Review and Investigations Committee, *Connecticut's Tax System* (2006), p. 101.

[4] OFA, *Tax Expenditure Report 1993-1995 Biennium.*

[5] OFA, *FY 08-FY 12 General Fund and Transportation Fund Budget Projections and Fiscal Information* (November 15, 2007), pp. 28-29. NOTE: OFA's total for credits against the insurance premiums tax ($26.2 million) is in error. The correct total of the credits listed is $27.2 million.

[6] The National Conference of State Legislatures has defined nine key principles of a high quality revenue system. One is that a tax system should be "neutral," i.e., it should not be "used to influence economic decisions on spending or investments." Legislative Program Review and Investigations Committee, *Connecticut's Tax System* (2006), pp. 9, 27, 201.

[7] While the Committee found that corporate income tax liability was reduced by about 23% through tax credits (at the time of the study), it was the 7,255 companies that filed a combined return that achieved the greatest reduction in their taxes through credits; their average tax before credits was $29,428 and after credits $14,801, a 50% reduction on average. The 5,325 companies that filed under the capital base method reduced their taxes through tax credits, on average, from $6,335 to $3,493 (a 45% reduction). By comparison, companies that filed under the net income method cut their taxes through tax credits by just 12% (from $14,208 to $12,511, on average). Legislative Program Review and Investigations Committee, *Connecticut's Tax System* (2006), pp. 99, 202.

[8] Legislative Program Review and Investigations Committee, *Connecticut's Tax System* (2006), p. 202.

[9] Legislative Program Review and Investigations Committee, *Connecticut's Tax System* (2006), p. 202. In 2003, eighteen of the Connecticut's 100 largest companies were not subject to the corporation business tax and paid the $250/year "business entity" tax. Another 18 of the state's 100 largest companies paid the $250 minimum corporation business tax. In short, more than 1/3 of Connecticut's 100 largest companies paid just $250 each in business tax in 2003.

[10] Legislative Program Review and Investigations Committee, *Connecticut's Tax System* (2006), Appendix P, p. P-1.

[11] Note that the data in this study predates the adoption of the "film" tax credits.

[12] The credit is available to certain companies that hire workers laid off through a restructuring that results in 10 or more staff layoffs.

[13] Saas, *Hollywood East? Film Tax Credits in New England* (New England Public Policy Center at the Federal Reserve Bank of Boston, October 2006)(urging that states evaluate the cost-effectiveness of these credits "relative to alternative policies designed to promote job creation and economic growth" and "also take into account the economic effects of measures needed to offset the revenue losses incurred by film tax credits in order to maintain balanced budgets," and citing, as the "most thorough empirical investigation to date" a Louisiana Legislative Fiscal Office Report on its film tax credit that found that "for every dollar of revenue lost to film tax credits, between 15 cents and 20 cents of revenue would be recovered from tax receipts generated by stimulated economic activity.")

[14] Conn. Gen. Stat. §§ 12-127zz, 12-211a. A bill that would have further reduced -- to 60% -- the pre-tax liability that could be offset by tax credits against the corporation business tax and insurance premiums tax was vetoed by the Governor in the 2007 Session. PA 07-248.

[15] Testimony on March 14, 2006 to the Commerce Committee.

[16] Conn. Gen. Stat. §12-217ee.

[17] R. Wysock, Office of Fiscal Analysis Report to Senator Tony Guglielmo (April 29, 2005). The report provided a listing of the tax liabilities (before and after credits) of Connecticut Magazine's top 100 Connecticut companies, of its largest banks, and of its fastest growing companies (but *not* by name).

[18] The clean alternative fuel credit for vehicles, equipment, and related filling or recharging stations includes a sunset provision. Conn. Gen. Stat. §12-217i. CT Department of Revenue Services, *Guide to Connecticut Business Tax Credits,* Informational Publication 2006(15) (April 24, 2007).

[19] The employer-assisted housing assistance tax credit was repealed by PA 06-189. The air pollution, industrial waste, employee training, work education, and new facilities tax credits were repealed by PA 97-295 when the new fixed capital investment and human capital investment credits were substituted. Two other credits are no longer available for reasons other than repeal: a) the insurance reinvestment fund credit (the funds are closed and no longer open to new investors. Also, under current law no credit is to be granted for investments made after December 15, 2015) and b) the traffic reduction program credit (that was available to Connecticut corporations that participated in traffic reduction programs in

federal EPA-identified "severe non-attainment areas" under the federal Clear Air Act. In 2004, EPA reclassified Connecticut's "severe" non-attainment area to one that is "moderate.")

[20] It found that ten of the twenty-six credits were used by five or fewer filers, and six of the twenty-six each account for $5,000 or less in credit value. Legislative Program Review and Investigations Committee, *Connecticut's Tax System* (2006), p. 203.

[21] Legislative Program Review and Investigations Committee, *Connecticut's Tax System* (2006), pp. 202-3. The study cited was CCEA, *The Economic Impact of Connecticut's Corporate Tax Policy Changes: 1995-2002* (re-released December 2005), p. i. CCEA's report used the REMI econometric model.

[22] Saas, *Hollywood East? Film Tax Credits in New England* (New England Public Policy Center at the Federal Reserve Bank of Boston, October 2006), p. 4.

[23] Conn. Gen. Stat. §12-217z.